Disputes Prevention Alternative for the Construction Industry

By Roger Woodhull, Executive VP/COO
Construction Risk Technology

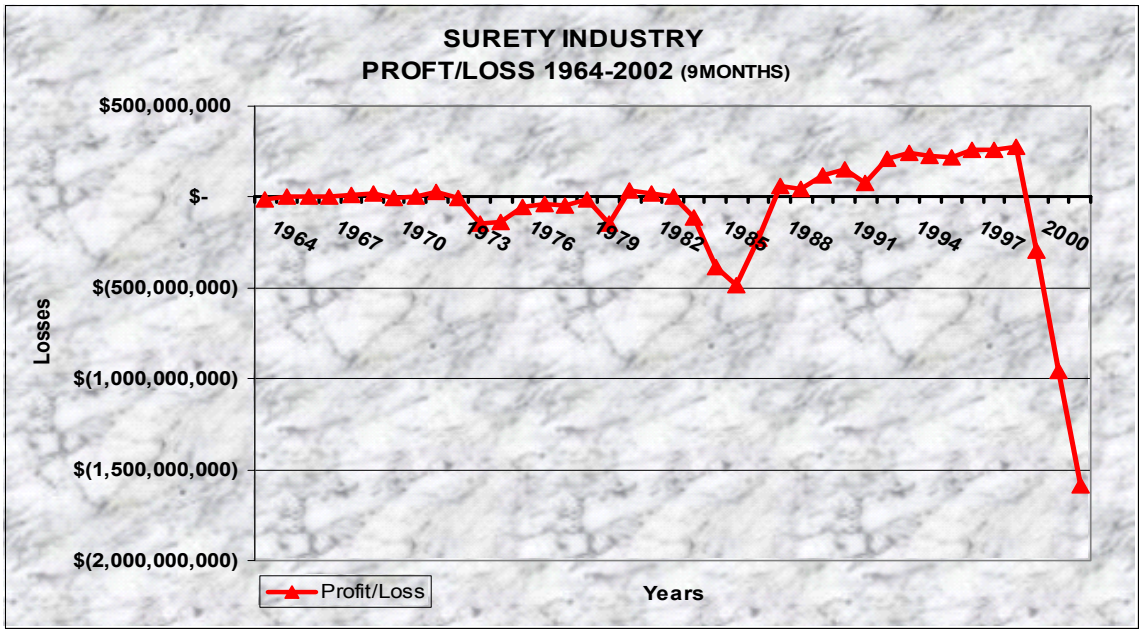
1. INTRODUCTION

Two serious issues confronting the construction industry are (1) the owner-contractor problem with regard to disputes and claims, and (2) the surety-contractor problem when a contractor finds himself in financial trouble.

The Owner-Contractor disputes and claims problems have caused the industry to incur substantial cost (one study found this cost to be 20% of the total dollars spent on construction), and have caused many financial failures. The genesis of these problems frequently can be traced to vaguely defined contract rights and responsibilities of the parties, principally when dealing with scope change. The lack of specificity in construction contracts has caused the courts to revert to "industry practice" and "prior dealings" to define those rights and responsibilities. This has lead to the development of a complex body of contract law which has its roots in equity principles, "making the injured party whole". The industry has attempted to deal with this problem by shifting more risk to the contractors using different procurement strategies like design build.

The surety-contractor financial problems have lead to losses in the surety industry (reflected in the graph below) which are almost 20 times those experienced over the past 40 years. The genesis of these problems can be traced to poor or incomplete bond underwriting guidelines which generally only look at a contractor's past financial performance and net worth. The surety industry has also been reluctant to impose financial controls on contractors which could control losses, perhaps because surety firms are afraid of loosing their client base. This has provided an environment which permitted contractors to take unreasonable risks that should have been resisted by the sureties. However, the sureties needed information which was not readily available to identify these high risk situations. The result has been a surety industry performance over the last few years which has been dismal to say the least.

What is suggested are changes in the process which will minimize the lack of specificity in the contract documents and minimize the opportunity for a contractor to take financial risks or prevent him from doing so. This is accomplished by three separate processes which are applied by owner s of construction to their procurement process. These processes are discussed in some detail later, but first it is appropriate to look at some basic elements of the industry which have contributed to this financial loss problem.



Unique Feature of Construction Acquisition Versus Other Product Procurement

In looking at this industry and the way in which it procures its products (i.e., constructed facilities), we see that there is a significant difference from all other industries.

First, the owner must select and make a contractual commitment to the product provider, in this case a contractor, without ever getting a chance to inspect the completed product (i.e., the constructed facility). This selection is normally based on price sometimes backed by performance and payment bonds. In almost all other product procurement processes used by industry and government, the owner gets an opportunity to evaluate the product before making the contractual commitment. The owner is trusting the low bid contractor to deliver a contract compliant product.

But what is contract compliant? Construction projects are complex and unique, and therefore the design documents which scope the project are generally complex and unique. This makes them subject to errors and omissions, and these defects become a liability to the project owner . Likewise, the site the project is constructed on is generally unique, and defining the characteristics of that site are prone to error, and become a liability to the owner . In addition, the facility user frequently comes up with last minute changes he wishes to have incorporated into the product. The final product can deviate significantly from the original design documents, and the owner will be liable for most of the scope changes that are encountered.

If that were not enough, when parties interpret the scoped design and the site definition, what one party may view as clearly and precisely defined, can become vague and subject to more than one interpretation by the other party. If the product was completed and available for inspection prior to the purchase, these scoping and ambiguity issues would not exist. Here is where the seeds of disputes are sown.

Given there can be an honest lack of agreement as to what is to be delivered, and the scoping documents and site description can be defective creating the need for changes, one can see that a

contractor has a potentially significant degree of variability in what he perceives that he is obligated to deliver. The price of the completed project may vary significantly depending on the contractor's interpretation of the contract scope and site description. Now impose a selection process which selects contractors based on low price, and the result can often be many disputes.

Since a contractor must be the low bidder to be successful, he must bid the least costly constructed project that he believes complies with the contract scoping documents. Therefore, the contractor is "incentivized" to deliver the lowest possible quality (i.e., least costly project). He also is "incentivized" to be creative in his bidding strategies in order to become the low bidder. This may lead to the less reputable contractors underbidding the job in expectation of recovering this cost through negotiated changes he sees will be required because of flaws in the documents. Once the practice is adopted by one or more contractors in a region, the other contractors have only two choices: take a similar approach or move to another market.

Neither of these choices is good for the marketplace.

2. THE OWNER-CONTRACTOR PROBLEM - MANAGING DISPUTES

The Construction Industry's Approach to Handling Contract Disputes

For years the construction industry has been using a reactive approach which focuses on a specific symptom, and not necessarily the underlying cause of disputes and claims problems, in order to manage construction claims cost growth. When construction disputes arise between the owner and the contractor which can not be resolved in negotiations, they turn the matter over to the attorneys, who, with the assistance of construction claims experts develop innovative arguments on behalf of their respective clients in order to prevail in the dispute. This process has resulted in the development of a complex body of construction contract law which attempts to define the rights and responsibilities of the parties to a construction contract when these rights and responsibilities are not addressed with some specificity in the contract.

Since this approach has not solved the problem in an acceptable manner for some owners, these owners have chosen to use different project delivery methods to avoid the litigious environment in which they have had to work. We have seen the emergence (or re-emergence) of design-build, build-own-operate, "master-builder", and other procurement strategies. The goal has been to transfer as much risk from the owner to the contractor as possible, to eliminate any possible cause for a dispute.

The result of this approach has been to:

- Reduce competition in the market place – Since design responsibility is being turned over to the contractor, the contract must include all elements of the project. This means that the construction contract size will be larger and more complex. Therefore, fewer contractors will have the skills or be able to get the required bonds. Less competition normally results in increased cost
- Increase contractor contingency costs – When a contractor takes on liability which is not well defined like the site conditions or facility performance requirements, he must add contingent cost for the potential unknowns. This means that the owner is paying for these potential contingencies, whether encountered or not.
- Reduce owner control over the outcome of the project – This is perhaps the most difficult characteristic of these new project delivery methods for a public owner to deal with. Without the ability to easily adjust the project scope to accommodate changing operational needs, the

owner must implement major contract changes, which can result in significant cost impacts on these larger construction contracts.

While these procurement strategies may reduce the number of disputes, many times the reduction in disputes is due to the lack of specificity in the contract performance documents, thereby making the owner's interpretation (i.e., intent) unenforceable. In other words, the owner may have intended a certain project feature, but the contractor provided a less costly solution to the scoped project element, and the owner is powerless to effect a correction because the specifications lacked the needed detail that will permit the owner to demand that his intent be enforced.

While private owners have used these alternative project acquisition techniques to purchase facilities quickly and with some degree of success, public owners may not enjoy this same success. That is because the public owners do not have the same flexibility when selecting contractors that private owners have. Frequently, private owners have contractors who do their work as a strategic partner, and this creates an incentive for these contractors to focus on the owner's best interest. Since the selection criteria for public work has to be completely or significantly tied to the bid price, the contractor's prior dealings with the public owner are generally not a consideration in the selection process. This leaves the door open to the less reputable contractors who may eventually develop the capability to compete in this new project acquisition environment. If this happens, the limited success public owners may have enjoyed using these new procurement strategies could be short lived. In addition, the more reputable contractors may find themselves in a more difficult position than they were in when owners used the traditional design-bid-build process; competing with less reputable contractors who are willing to reduce the level of quality and who will have more flexibility to do so because of the lack of specificity in the performance contract requirements.

What Alternative Does the Owner Have?

How can the public owner procure their needed facilities in the existing marketplace, and yet avoid these potential problems described above?

The answer is simple - minimize the number of scope changes which can cause a dispute to arise, and provide contractors with an incentive to manage the impacts and minimize the cost increases created by these changes. To accomplish this requires that the owner take a proactive approach and deal with these issues in the contract provisions. This is done by

- Providing the owner with some SCOPE FLEXIBILITY to adjust the contract scope while ensuring that the contractor is properly compensated,
- Including sufficient SPECIFICITY in the contract such that compensation for work scope changes is objectively determined (including indirect costs) and contractor responsibilities are clearly defined, and not determined by "industry practice" or "prior dealings"
- Assigning manageable RISKS to the appropriate party (i.e., the party in the best position to manage the risk). This means transferring to the contractor some small, quantifiable risks which are best managed by the contractor who controls the resources to minimize the impact
- Including MINOR BREACH REMEDIES in the contract to permit enforcement of all contract obligations

- Including NOTICE AND DOCUMENTATION obligations to provide an accurate and indisputable record of the events

- **SCOPE FLEXIBILITY** – Anyone who has been in construction for even a short time knows that scope changes on any project are inevitable. It should also be obvious that many of these scope changes can be anticipated. Who has not been on a job where unsuitable soil or hazardous material is encountered; or where unidentified utilities are found. If the owner's project team were to have a strategy session prior to bidding in order to identify what possible changes might be encountered on a specific project, a list could be developed of 50 to 100 such possible scope changes. Each of the anticipated changes which had a high probability of occurrence could be included as a scoped element of work in the construction contract with a stipulated quantity and price, or an allowance. In addition, the Owner should reserve the right to vary the stipulated quantity by plus or minus 100%, so that the work could be deleted from the contract if the item of work was not encountered. There would be a need for language which would shift the risk to the contractor to accommodate this work within the original contract time. While this approach does shift some risk to the contractor, a well-managed contractor should be able to deal with this coordination task, and will therefore probable not assign a significant contingency cost to the effort.

- **SPECIFICITY** – There are a number of items which require more specificity in defining the contractor's compensation and obligation. Several of these items are:

    - **Indirect Cost Compensation -** Indirect costs include, but are not limited to extended overhead, home office overhead, lost productivity, and acceleration. The actual cost of these "indirects" are difficult to calculate, and can vary significantly from contractor to contractor. A body of law has developed which has as its goal to "make the impacted party (generally the contractor) whole" when determining allowable cost recovery, once entitlement is established. While this is a noble goal, it is very difficult if not impossible to attain. It frequently presumes that the cost impact which befalls a contractor is due solely to the owner's interference with the contractor's work plan. This owner's interference comes most frequently in the form of scope changes for which the owner is liable. The complexity of establishing the dollar value of these indirect costs, and the reliance on contractor records, often makes it difficult for an owner team to negotiate an agreeable settlement cost in the field. The end result can be a legal suit, which is often extremely costly for both parties. This situation represents a significant risk exposure to the owner, and this risk should be addressed in the contract documents. The use of an objective formula which approximates the impact cost of the owner-directed change for a "typical" contractor is a better approach. This is similar to the liquidated damages an owner might include in a contract for the contractor's failure to meet contract mandated milestones. The advantages this solution offers are fourfold: **first**, all contractors will recover the same amount; **second**, access to contractor cost records is not a prerequisite to determining the amount of contractor entitlement (i.e., actual damages) so delays will be avoided; **third**, contractors will have an incentive to manage the impact and accelerate where necessary to mitigate the delay because his compensation is no longer tied to the actual impact cost; **fourth,** the well managed contractor will have a competitive advantage because his ability to manage the impacts will minimize his costs.
    - **Contractor Design Build Responsibility** – It is important that the contract clearly defines the contractor's design responsibility. Too often this

responsibility is buried in the contract documents or is not addressed but instead presumed as an "industry or trade practice". These design responsibilities should be included with some specificity, and highlighted in the body of the contract project specific general conditions to avoid creating a basis for dispute and deferring the determination to a court of law.

- **MINOR BREACH REMEDIES** – Sometimes, a contractor's failure to meet his contract obligation can result indirectly in an impact on the project. For example, a contractor's failure to submit shop drawings on a contract stipulated date can result in a delay in discovering a site condition or design error. While this design error or site condition may not have had an impact on the project if it had been identified earlier, because the shop drawings are late, it does have an impact on the contractor's critical path schedule. A more specific example might be a submittal, which was due within the first three months of the contract, gets submitted eight months after contract award (i.e. five months late). As a result of the submittal review, the designer finds an error in the drawings which requires a scope change. Typically, delays which emanate from a scope change would be the owner's liability. In this example, the owner's recourse against the contractor for failing to meet his submittal schedule deadline was to use his remedy for breach of contract. Unfortunately, the only remedy typically available is "termination", and this is not a remedy many owners would elect to take in this stated example. This minor breach situation represents a significant RISK EXPOSURE for the owner, and it should be addressed in the contract documents. One technique is to shift the risk of delay to the contractor for that period of time he is in breach of his contract mandated schedule.

- **SHIFTING RISKS** - How much risk has been shifted by the contract document should be a critical concern of the owner. If the contract has shifted risks which the contractor cannot manage, and which may cause the contractor not to bid or include large contingency costs, this will increase the cost and likelihood of a dispute and possible claim. Such risk-shifting provisions may even be determined unenforceable by the courts, leaving the owner with no defense against less ethical contractors. If the contract does not shift those risks which only the contractor can manage to the contractor, the owner may find itself at the mercy of unethical contractors when trying to deal with problems that arise from scope changes. Some risks the contractor can best manage are minor deviations in the plan locations of existing structures, water conditions found on site, certain restrictions imposed by environmental or political concerns, and certain performance requirements, to mention a few. These need to be placed clearly within the contractor's scope of responsibility to manage as he chooses, and a compensation mechanism has to provide the contractor adequate compensation. This described approach tends to give a competitive advantage to well managed contractors who can manage impact costs effectively. It also serves to discourage contractors from taking a bidding risk in hopes of recovering costs through aggressive negotiation.

- **NOTICE AND DOCUMENTATION - D**etailed information is critical in developing an accurate analysis of the entitlement and quantum elements of a contractor claim, yet frequently the contract is silent or lacks specificity regarding the contractor's notice and documentation obligations. Notice is an important element of any impact mitigation effort, and documentation provides the facts necessary to determine entitlement and value. Also, documentation requirements can be useful in forcing surety companies to get actively involved without the owner being concerned that notice of poor contractor performance may make them liable for impacting the contractor's bonding capacity. These requirements also serve to favor the well managed contractor who will generally have such notice and documentation systems in place.

3. THE CONTRACTOR-SURETY PROBLEM - MANAGING CONTRACTOR FINANCIAL FAILURES

FUNDS CONTROL

Contractor's financial failure frequently results from a combination of events including underestimating the cost of work and not managing resources in a cost effective manner. The contractor sometimes covers these cost over runs by drawing funds from one project to cover the over run and cash flow problem on another project. This practice can only be successful for a short period of time, and requires that the over run be offset by profits from the other project. This control the contractor has over the project finances allows the contractor to take unreasonable risks, and it is the surety and owner that suffer the consequences of bad judgment.

It is suggested that the owner impose the same controls over the project funds that the surety industry uses regularly when managing a contractor in financial distress. This funds control process can prevent the contractor from misusing and commingling project funds in a manner described above. The approach involves imposing the process through a provision in the general conditions in a manner that is not intrusive to the contractor, or requires that the contractor disclose sensitive financial information.

Such a process would very likely be strongly supported by the surety industry, and could increase bonding capacity of subcontractors interested in bidding the project. This increased competition would likely drive bid costs down, and will ensure that the subcontractors and major vendors get paid in a timely fashion. This benefit alone is enough for some public owners to want to use the process, because it ensures that the small business subcontractors are not subject to the financial strain created by prime contractors who pay bills very slowly. Another benefit for owners, which is not so obvious, is the management responsibility which is transferred to the prime contractor. With the prime contractor loosing control of the disbursement of payments, he must control subcontractor "front loading" of his monthly billings to avoid those subcontractors getting paid more of their actual work progress.

CONTRACTOR CERTIFICATION

Both the project owner and the surety providing the project bonds are as interested in the contractor having a successful and profitable contract, as the contractor is. A financially insolvent contractor creates significant problems for both of these parties, and frequently creates an adversarial claims environment which must be weathered before the project is completed and operational. It is therefore prudent for both the owner and surety firm to acquire information about the contractor's management and technical capability before they "underwrite" the contractor's ability to deliver the completed project. While this type of review will not necessarily prevent the contractor from intentionally taking a risk on a very low bid, it can reveal a potential contractor weakness in the management and execution of complex construction projects, and this can allow these parties to make an informed decision on the potential risks they are "underwriting". They can also help prevent a contractor from unintentionally taking a risk he may not be capable of managing.

A technical and management review and rating process now exists to help sureties, owners, and other credit providers evaluate the level of risk a specific contractor may present. The certification process looks at a contractor's strategy, resources and systems as well as the linkage

of these three primary business considerations to each other. The linkage evaluation is critical to the certification process because, while systems and resources will not overcome fundamental flaws in strategy, resources can compensate for less than optimal systems, and, resources and systems can be modified to accommodate changes in strategy. The underlying fact is that the most effective organizations are those whose resources and systems complement each other and supplement the overriding business strategy. For this reason the certification scoring systems was developed not to quantify some ideal contractor management system, but rather to quantify the individual contractor being evaluated based upon the specifics of their market and organizational profile.

Sureties are now aware of the availability of this process. They will be utilizing it in their prequalification process. In fact, even the contractors are supportive of the process. As one contractor stated, "Certification will separate the GOOD contractors from the MARGINAL ones."

Contractors that fail to attain a certain score or where various segments that were examined look soft, the underwriter can take that information into consideration in their underwriting.

The certification system could be endorsed by owners to provide a qualification threshold for bidders on some projects. Contractors who are confident of scoring high in the certification process welcome certification. With such a system in place, quality contractors will not have to be as concerned about unqualified contractors under bidding the project, and the owner will benefit by avoiding disputes and claims.

4. SUMMARY

The paper has address several techniques that permit owners to better manage the project risks, which emanate from the inevitable project scope changes, while still retaining control of the project. These solutions focus in a large degree on prevention, and attempt to avoid having to use the complex and costly solutions offered by the legal system and the courts to determine entitlement and "quantum" issues.

The process includes better defining the parties' rights and responsibilities in the contract documents, limiting the contractor's control over project funds, and getting an objective evaluation of the contractor's technical and management capabilities. It is hoped that some of these process elements will lead to a more productive and positive project outcome, with fewer claims and a less adversarial project environment.